Department of Finance

News Release

Immediate release

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Canada's New Government Unveils Proposed Improvements to the Application of the GST/HST to the Financial Services Sector

The Honourable Jim Flaherty, Minister of Finance, today released draft legislation, explanatory notes and a backgrounder for several measures aimed at improving and streamlining the application of the goods and services tax/harmonized sales tax (GST/HST) to the financial services sector.

"The financial services sector is a key element of the Canadian economy. Ensuring that the tax system functions smoothly and fairly in relation to it will support its continued success both at home and abroad. This ultimately benefits consumers and the Canadian economy" said Minister Flaherty.

The draft legislation released today will address GST/HST advantages that currently exist in favour of imported financial services over comparable domestic services.

The draft legislation also proposes new legislative framework for the GST/HST input tax credit allocation regime applicable to financial institutions. The framework will streamline the application of the GST/HST input tax credit rules for these institutions and reduce the uncertainty arising from the lack of specific guidance in the current legislation.

The Minister also announced that stakeholder consultations would be undertaken on the following proposals:

- Replacing the complex system of legislative and administrative rules that currently apply to different pension plan trust structures with a new, uniform GST/HST rebate system that will apply fairly and equally to all such structures; and
- Introducing a new GST/HST annual information schedule for financial institutions to improve GST/HST reporting in the financial services sector.

Printed copies of the documents released today are available for $10 from the Department of Finance Distribution Centre. For detailed information on the draft legislation and explanatory notes visit www.fin.gc.ca.

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Backgrounder

Imported Supplies

Goods and services tax/harmonized sales tax (GST/HST) applies not only to domestic purchases but also to imports of goods and services. In the case of imported services and intangible personal property, tax collection at the border would be impractical. As a result, specific rules under the *Excise Tax Act* (ETA) require certain recipients of these imports to pay tax on a self-assessment basis. Due to a Tax Court of Canada decision regarding the applicability of this rule to cross-border dealings between the foreign and Canadian branches of a non-resident insurance company, the compliance and administration of this rule were called into question. As well, certain comments in this decision had been taken to mean that many taxable supplies (e.g., administrative services) could potentially be treated as exempt supplies (e.g., financial services) to avoid GST/HST, which would have an impact not only on dealings between branches of the same person (as in the case under decision) but also on supplies between separate persons.

To address these issues, on November 17, 2005, the Department of Finance issued a news release together with a detailed backgrounder announcing legislative proposals to amend the ETA. The proposals contained a clarifying amendment respecting the rules that apply to taxable imports of services and intangibles between separate branches of the same person. The proposals also contained a new rule, applying only to financial institutions (FIs), which requires an FI with a presence outside Canada (e.g., in the form of a branch or a subsidiary) to self-assess GST/HST on certain expenses incurred outside Canada that relate to its Canadian activities.

The government is now releasing proposed legislation relating to the clarifying amendment and the new rule for FIs. The proposed new rule for FIs applies effective from the date it was announced (i.e., November 17, 2005). The proposed clarifying amendment to the existing self-assessment provision applies from the day that provision first came into force (i.e., December 17, 1990), though from November 17, 2005 onwards, the new rule rather than the existing self-assessment provision will apply to FIs.

Input Tax Credit Allocation Methods of Financial Institutions

FIs are entitled to claim input tax credits (ITCs) to recover GST/HST paid on inputs used to make taxable supplies (generally, supplies on which they are required to charge GST/HST) but cannot claim ITCs to recover GST/HST paid on inputs used to make exempt supplies (generally, supplies on which they are not required to charge GST/HST). Where an input is used to make both taxable and exempt supplies, the FI must apply a method to allocate the use of that input between taxable and exempt supplies in order to determine the percentage of GST/HST paid on the input that can be recovered as an ITC. In recent years, questions have been raised regarding which allocation methods are appropriate to use by an FI to determine its ITC entitlement. In order to address this uncertainty, amendments are proposed to the ETA that will provide greater clarity and

direction to all FIs respecting which ITC allocation methods they can use. These proposed amendments provide more detailed ITC allocation rules for FIs. In addition, the proposed amendments particular to large banks, insurers and securities dealers require them to use a prescribed percentage or to obtain pre-approval of the Canada Revenue Agency (CRA) to use their own ITC allocation methods.

The proposed amendments apply generally to fiscal years of an FI that begin after March 2007. The proposed amendments requiring the large banks, insurers and securities dealers to obtain pre-approval for their own allocation methods do not apply until fiscal years of an FI that begin after March 2008, in order to give these FIs more time to obtain pre-approval for their own ITC allocation method proposals. For the first year that begins after March 2007, the proposed amendments allow a special transitional election for these FIs to use an allocation method that has been approved by the CRA in respect of a prior fiscal year.

A New GST/HST Rebate for Pension Plan Trusts

Generally, an employer engaged in commercial activities can claim ITCs to recover GST/HST paid on expenses. Where a pension plan trust is established to provide pension benefits for its employees, the employer is not able to claim ITCs to recover GST/HST paid on expenses relating to the activities of the pension trust. This is because, under the GST/HST, a pension trust is a separate person from the employer and is treated as a financial institution. As a result, to the extent that the pension trust provides exempt financial services in managing its investments and providing pension payments, it, generally, cannot recover GST/HST it pays on its expenses.

While employers cannot currently claim ITCs for expenses relating to the pension trust's investments (representing about two-thirds of pension-plan-related expenses), they may claim ITCs for certain eligible expenses incurred in establishing and administering the pension plan. These eligible expenses include expenses relating to collecting pension plan contributions, paying plan benefits and maintaining pension plan records (these expenses make up about one-third of pension-plan-related expenses).

Due to factors such as the clear existence of the pension trust as a separate person, the provision of financial services by pension trusts, which restrict the claiming of ITCs, and complications created by the range of terms in different pension trust agreements, the practical application of the current set of rules is not clear and may not provide equitable results in all circumstances.

In 2000, an amendment to the *Excise Tax Act* was passed allowing a particular class of pension trusts (i.e., multi-employer pension plan trusts) to claim a rebate of 33% of the GST/HST paid on their expenses. This rebate provides multi-employer pension plan trusts with GST/HST relief in an amount equivalent to about one-third of total GST/HST costs of the plan. As previously noted, this is approximately the proportion of pension-plan-related expenses that would be eligible for ITCs.

The government recognizes the need to more generally address the issues concerning pension trust entitlement to ITCs and provide a common treatment for all pension trusts to ensure that the full benefits of pension plan GST/HST relief accrue to pension trusts so that they can better provide benefits to pensioners. Therefore, it is proposed that the current ITC and rebate provisions for pension trusts be replaced with a single rebate system, similar to the multi-employer pension plan rebate, for all employer-sponsored pension trusts. Generally, this proposed new rebate would be available for GST/HST paid on any expenses relating to pension plans. The key features of this rebate are described below.

- The rebate would be provided to all employer-sponsored pension trusts, whether they are GST/HST registrants or not.

- The only pension trusts that would not be eligible for the rebate would be those for which 10% or more of the contributions to the plan are made by listed financial institutions (since listed financial institutions cannot generally claim ITCs to recover GST/HST paid on their expenses).

- The rebate would apply to GST/HST paid on all pension plan expenses, whether they are administrative or investment-related expenses.

- The rebate would be for 33% of the GST/HST charged on all pension-plan-related expenses. This rebate percentage reflects the proportion of pension trust expenses generally eligible for ITCs.

- Employers engaged in commercial activities would become entitled to claim ITCs in respect of all taxable inputs they use in relation to pension plans, including pension-investment-related expenses as well as administrative expenses. However, the employer will also be deemed to have made taxable supplies of all such eligible inputs to the pension trust. With respect to these deemed taxable supplies, the pension trust will be deemed to have paid, and the employer will be deemed to have collected, the GST/HST. This essentially cancels the employer's ITCs and allows the pension trust to claim a rebate on the relevant expenses.

The result is that the rebate would be provided to the pension trust regardless of whether the pension expense was incurred by the pension trust itself or by the employer. However, where the employer incurred the expense, the pension trust would have to obtain documentary evidence from the employer to support the position that GST/HST in respect of the expense was paid.

The Department of Finance is seeking input from industry stakeholders and also welcomes comments from any other interested parties. Any comments on the proposal should be submitted by April 30, 2007 to the Sales Tax Division of the Department of Finance at the following address:

Sales Tax Division, Tax Policy Branch
Department of Finance
Ottawa, Ontario K1A 0G5

A New GST/HST Annual Information Schedule for Financial Institutions

A key objective of the GST/HST has been to keep the information-reporting requirements to a minimum. As a result, currently, very limited information is required from businesses on their GST/HST returns. However, the government has always recognized the need for supplementary GST/HST information from the FI sector given the complexities in the sector and the specific GST/HST rules that apply to FIs. Additional GST/HST data from FIs will help to improve compliance, maintain an efficient and effective tax administration system, assess policy and legislative changes in a timely manner and allow the government to better meet its commitments to the provinces under sales tax harmonization.

Generally, FIs, as providers of tax-exempt financial services, cannot recover most of the GST/HST they pay on inputs. As a result, FIs can be viewed as taxpayers/consumers. This position is different from most other businesses, which make taxable sales of goods and services, collect and remit tax and receive full ITCs for tax they pay. While they are generally providers of tax-exempt financial services, a significant number of FIs also engage in taxable activities both in Canada and internationally. As a result, FIs are subject to a range of unique rules and therefore, currently need to make a variety of calculations to compute the information summarized on the GST/HST return. The proposed annual GST/HST information schedule for FIs is intended to provide a working document to record the results of this analysis.

Requirement to File

The proposed annual GST/HST information schedule would be filed once per fiscal year, within six months after the end of the fiscal year by a "financial institution" (within the meaning of subsection 149(1) of the *Excise Tax Act* (ETA)) that is a registrant and has total annual revenue (as stated in its financial statements, which are filed with its income tax returns) in excess of $1 million.

The information schedule would be implemented for fiscal years of FIs commencing after 2006. This means that an FI with a calendar year as its fiscal year would be required to file its first annual information schedule (for 2007) by June 30, 2008.

Information Requested

It is proposed that the following information be provided in the annual information schedule in respect of a fiscal year of the FI.

Identification

In addition to the name, address, contact information and fiscal year the information schedule relates to, the FI will be required to include the following information in the identification section:

- Self-identification as to whether the FI was a selected listed financial institution (SLFI) (within the meaning of subsection 225.2(1) of the ETA), a listed financial institution (within the meaning of paragraph 149(1)(*a*) of the ETA) that is not an SLFI, or a *de minimis* financial institution (within the meaning of paragraph 149(1)(*b*) or (*c*) of the ETA) during the fiscal year; and

- The North American Industry Classification System (NAICS) code that applies to the primary business activity of the FI in the fiscal year. Generally, the NAICS code remains the same from year to year. The FI will be required to verify and change the code if its primary business activity has changed.

Analysis of Information

An FI would be required to provide an analysis of the information provided on the GST/HST return.

- Total sales and other revenue made in the fiscal year (this information could be taken from the FI's financial statements) with a breakdown of the following categories. Revenue relating to: supplies of zero-rated financial services, supplies of exempt financial services, non-financial zero-rated supplies, non-financial exempt supplies, non-financial taxable supplies at 6%/14%, other non-financial supplies and any other revenue.

- A breakdown of the "Total GST/HST collected/collectible and adjustments" amounts on GST/HST returns of the FI filed for all reporting periods in the fiscal year:

    - Total GST/HST collected/collectible during the fiscal year, excluding the adjustments

    - Total adjustments made as additions to net tax on GST/HST returns of the FI filed for all reporting periods in the fiscal year

    A breakdown of the above total adjustments to net tax with the following amounts identified separately:

- Credit notes received or debit notes issued (e.g., for tax paid in error, price adjustments and patronage dividends)
- Bad debts recovered
- Recapture of ITCs on leased vehicles
- Recapture of ITCs on food, beverages and entertainment expenses
- Other adjustments

- A breakdown of the "Total ITCs and adjustments" amounts on GST/HST returns of the FI filed for all reporting periods in the fiscal year:
  - Total amount of ITCs claimed on GST/HST returns of the FI filed for all reporting periods in the fiscal year:
    - All amounts claimed as ITCs for all reporting periods of the FI in the fiscal year
    - All amounts claimed as ITCs for reporting periods of the FI's preceding fiscal years
  - Total adjustments made as deductions in determining net tax on GST/HST returns of the FI filed for all reporting periods in the fiscal year

    A breakdown of the above total adjustments to net tax with the following amounts identified separately:
    - Credit notes issued or debit notes received (e.g., for tax paid in error, price adjustments and patronage dividends)
    - Bad debts written off
    - Deductions for rebates paid or credited to purchasers (e.g., rebates for segregated funds)
    - Other adjustments
- GST/HST paid/payable during the fiscal year on imported supplies, showing separately the GST and the provincial component of the HST on imported goods and imported supplies of services and intangible property.

Additional Information

The additional information (set out below) is related to information on the GST/HST return.

- Total GST/HST paid/payable during the fiscal year.

- Total expenditures in the fiscal year (this information could be taken from the FI's financial statements) in the following categories: purchases of financial services, purchases of taxable supplies at 6%/14%, other non-financial purchases and any other expenditures.

- Supplies imported from head office or branches, related persons and third parties during the fiscal year in the following categories: taxable goods, taxable supplies other than goods, and financial services.

- Supplies exported to head office or branches, related persons and third parties during the fiscal year in the following categories: zero-rated tangible personal property, zero-rated intangible personal property and services other than financial services, and zero-rated financial services.

- A breakdown of the ITCs claimed in the fiscal year by ITC allocation methods used. The sub-fields will show separately the amount of ITCs claimed for different types of inputs using allocation methods based on the new draft legislative proposals relating to ITC allocation methods of FIs.

- Details respecting change-in-use of capital property due to acquisition of a business, amalgamation, winding-up of a corporation and group elections for exempt supplies and other reasons.

- Supplies made to, and supplies received from, related persons under group elections for exempt supplies.

- Income allocated to various provincial and territorial jurisdictions and outside Canada, as provided for purposes of determining the provincial income tax.

FIs generally track the types of information requested and maintain books and records accordingly for audit verification purposes. The information requirements that may be relevant will depend on the nature of the business of the FI such that all of the information may not be required in all cases. For example, an FI that has no group relief elections and no cross-border supplies would not be required to complete the fields specific to those items.

The government is consulting the FI industry associations for their input prior to the release of the proposed information schedule in a final prescribed form. Interested parties are invited to send their comments on the proposals by April 30, 2007 to the Sales Tax Division of the Department of Finance at the following address:

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Department of Finance
Ottawa, Ontario K1A 0G5